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5. Impact of Financial Performance on CSR Spending in India

Ms. Rekha Rani
Assistant Professor,
Department of Commerce,
Indraprastha College for Women,
University of Delhi & Research Scholar,
Dept. of Commerce, CCSU, Meerut.

Dr. Shweta Sharda
Associate Professor,
Department of Commerce,
Indraprastha College for Women,
University of Delhi, Delhi, India.

Prof. Manoj Kumar Agarwal
Principal,
NAS College, CCSU,
Meerut.

ABSTRACT

Business uses society's resources, so businesses should contribute to the well-being of society. In return of extracting resources from society, the business has to return what it owes in the forms like promotion of education, health care programs, protection of national heritage, etc. With amended legislation to mandate CSR spending by Indian firms, The Companies Act, 2013 acted as a milestone in shifting the stance of companies from passive philanthropy to active involvement in CSR activities. According to stakeholder and agency theories, fulfilling CSR has its costs and benefits, as a double-edged sword. The objective of this paper is to examine the impact of the financial performance of the companies on the CSR expenditure of selected Indian firms. The study is based on an empirical investigation of the relationship using a panel dataset of 284 Indian firms listed on the Nifty 500 over the period 2015 to 2022. The panel regression analysis revealed heterogeneous behavior of the financial performance of the firms. The findings of the study confirm the positive significant impact of accounting performance indicators on the level of CSR expenditure in companies. The results indicate that CFP has a significant impact on the company's CSR spending, in other words, companies with higher financial performance will have greater CSR exposure. It recommends that companies should not pamper investors with higher dividends from

higher earnings by neglecting CSR investments, but rather meet society's expectations through the allocation of funds towards CSR activities. In reality, the CSP-CSR relationship acts in a circular form, it simply exists in both directions.

KEYWORDS

India, Corporate Social Responsibility, Financial Performance, ROE & ROA.

Introduction:

Corporate social responsibility (CSR) is the notion that organizations, particularly businesses, are no longer based on a single bottom line but rather a triple bottom line (Mandaika and Salim, 2015). CSR is essential for firms to gain legitimacy, it helps a firm in differentiating itself, improving its image and reputation, and employee satisfaction, and motivation (Schwaiger, 2004). A reputed firm can further improve its relationship with bankers, and investors, facilitate easier access to its capital, and attract a better workforce, and more customers, and thus have more profitability in the long run. Since it plays a role in improving credibility amongst its significant stakeholders (Pradhan, 2016), a firm would build up a stock of reputational capital and hence boosts its financial performance by investing in superior social responsibility. According to Godfrey et al. (2009), participating in CSR activities can bring moral capital to related parties, and then this moral or goodwill capital will act as a protector - like insurance when negative events occur (Godfrey et al., 2009). Hategan et. al (2018) observed that companies are "doing good" when they are "doing well" and companies that are not doing well financially are involved in CSR activities with the motivation that CSR will pay off. A company should therefore spend on CSR to improve its goodwill in the eyes of its stakeholders and enjoy the resulting benefits.

CSR plays a crucial role in determining Corporate Financial Performance (CFP) from a strategic viewpoint, it brings greater benefits than costs, resulting in a positive CSR-CFP relationship. However, analyzing the impact of corporate social responsibility on financial performance is a complex issue. The interference of various factors makes the CSR–CFP relationship complicated, nonetheless one can argue that companies should now reconsider their CSR spending to earn sustained growth. There is much evidence that CSR is improving financial performance in developed and developing economies, but stakeholders still expect much more CSR practices than those actually doing in organizations (Salehi & Azary, 2009). Despite its significance, only a few CSR studies focusing on image, reputation, etc. in the Indian context emerge (Pradhan, 2016 etc). Although scads research on the relationship between corporate social responsibility and financial performance exists, the literature is still inconclusive. Financial performance is positively, negatively, or neutrally impacted by corporate social responsibility (CSR) according to Mcwilliams and Siegel (2002). No conclusive answers have yet been found so as to clarify if CSR affects business performance or vice versa, and, research on the topic has been concentrated in developed economies (Crisostomo et. al, 2011).

With amended legislation to mandate CSR spending by Indian firms, the Companies Act, 2013 acted as a milestone in shifting the stance of companies from passive philanthropy to active involvement in CSR activities. The mandated CSR spending may impose an additional economic burden on the companies however, it has been conceptualized in a way

that it doesn't hurt the company, shareholders, and stakeholders disproportionately, and that it ultimately results in net social welfare gain (Sarkar and Sarkar, 2015). This study is therefore undertaken to inspect the impact of the financial performance of the firms in influencing the decision to invest in CSR, using firm-level panel data from 2015 to 2022 on 284 Indian listed companies constituent of the Nifty 500. We observed a dearth of studies that investigate the impact of CFP on CSR, thus, added CFP as an independent variable, namely ROA and ROE, and used CSR as the dependent variable, which is a newer aspect that required investigation. The results confirm the positive influence of the company's performance on its CSR decisions. In response, the report recommends that companies do not ignore their social responsibilities by paying inventors increased dividends from higher earnings, but rather help society by allocating funds towards social responsibility. As a matter of fact, CSP-CSR relations are circular in nature, they simply exist in both directions.

The rest of the paper is organized as follows: the next section discusses the theoretical background and then reviews the related literature, and then the research design provides data description and construction of sample and methodology, thereafter the analysis of results is presented and finally, the conclusion is drawn.

Theoretical Background, Literature Review & Hypothesis Development:

CSR is considered an imperative part of management science literature in recent years. The relationship between CSR and CFP has been examined intensively from two different perspectives. The first is from the perspective of neoclassical economics and traditional management theories. In the late 60s, Milton Friedman came up with an argument, that there is nothing like the social responsibility of business. CSR is a "fundamentally subversive doctrine" in a free society, otherwise, the company will be in a detrimental position; the only goal for the business is to increase profit while respecting legal and ethical decorum (Friedman, 1970). The higher the share price of a company, the higher the shareholders' income, which positively affects the company's value. Consequently, based on the assumption that profit maximization is a firm's key objective, it is proposed that companies should consider their shareholders as the primary stakeholders and allocate their resources to satisfy this group.

Contrarily, the stakeholder theory suggested that CSR acts as a tool for generating competitive advantage and ultimately improving CFP. This stakeholder-oriented strategy was fundamentally in contrast to Western countries, where companies' primary goal was to generate profit for their shareholders. CSR helps in building a positive relationship with customers, attracting motivated employees, lowering companies risk, and spreading positive word of mouth which might otherwise impose a cost (Bird et. al, 2007). However, in a society where tipping or donating to charity has not always been a common practice, money, and financial aid have often come from existing networks or close relationships. It used to be a strange idea that firms should share a portion of their profits with issues or people they are not connected with. Akpinar et. al (2008) challenged the assumption that managers consider all stakeholders equally important and they contend that managers prioritize stakeholders instead, and proposed a stakeholder-weighted CSR will alleviate the 'stakeholder misalignment' problem which is articulated to be one of the reasons why there are inconclusive results about the relationship between CSR and CFP. The debate between the two viewpoints has still been going on as the empirical results for the CSR–CFP

relationship is ambiguous, inconclusive, or contradictory (Friede et al., 2015). Nevertheless, in today's context, it is imperative for companies to behave in a socially responsible manner to reap benefits in the longer run.

These theories thus led to the long-held belief that there is a trade-off between CSR and CFP. Accordingly, there are many studies that identified the relationship between CSR and performance(Cho et. al, 2019; Santoso and Feliana, 2014; Harjoto & Laksama, 2016). Some found CSR as an important driver for enhancing firm performance while others argued that the efforts to satisfy other stakeholder groups would have a negative impact on firm performance. For instance, Wright and Ferris (1997) examined the effect of divestment in South Africa (as a proxy for CSR) on stock market performance. Using data from 116 companies for 10 years in cross-section industries, the study showed that share price is affected negatively by announcing divestment in South Africa. These results are supportive of the premise that non-economic pressures may influence managerial strategies rather than value-enhancement goals. This line of thinking argues that those engaged in CSR activities incur a competitive weakness because they incur costs that should have been borne by other institutions. For instance, eco-friendly operations, philanthropy, customer welfare, health care centers, and environment preservation.

Likewise, Hemingway and Maclagan (2004) believe that CSR is a cover-up for fraudulent activities imitated by management, which imposes negativity in CSR. Skeptics have accused CSR as a projection of good image, regardless of their unpublicized unethical practices (Caulkin, 2002). Lopez et al. (2007) analyzed the relationship between accounting-based performance indicators, including the growth of profit before taxes, ROA, and ROE and CSR in European firms. They found that the relationship between these variables is negative, confirming that the effect of sustainability practices on performance indicators is negative in the first years in which they are applied. Kim and Yoo (2022) investigate the impact of corporate opacity on a firm's CSR performance and found that corporate opacity is negatively associated with CSR performance and that the CSR of opaque firms does not align with long-term financial performance. Prior et. al (2008) demonstrated that the combination of earnings management and CSR has a negative impact on financial performance. The estimation of a set of econometric models has provided results that exhibit a trend toward a negative effect of CSR on firm value in Brazil, which appears to be strongly influenced by social action relative to the relationship with employees and environmental concerns (Crisostomo et. al, 2011).

Several studies have supported the positive nexus, for instance, Waddock and Graves (1997) assessed 469 companies while surrogated KLD measurement for CSR. He examined the impact of both slack resources and good management theory and found CSR positively associated with prior and future financial performance. Peng and Yang (2014) used a set of Taiwanese listed companies' unique pollution control data to measure CSP and concluded that CSP does not affect short-run FP but positively affects long-run FP. Hammond and Slocum, (1996) highlighted that CSR can enrich corporate reputation and lower financial risk, thus firms having minimal chance of getting bankrupt, compared to non-CSR firms. It has a positive effect on the financial performance of manufacturing companies listed on the Indonesia Stock Exchange, according to a study conducted by (Maryanti and Fithri, 2017). Wang & Sarkis (2017) analyzed that a rigorous CSR governance mechanism would result in good CSR outcomes, which would further contribute to good financial returns. Harjoto & Laksama (2016) examined the relationship between CSR and the deviation of optimal

risk levels, they found that stronger CSR performance was associated with smaller deviations from the optimal risk level. Moreover, they examined the mechanism by which CSR has an impact on financial performance and found that CSR performance is positively related to financial performance because CSR minimizes and avoids risks.

Palmer's (2012) study discovered that increased CSP leads to increases in the gross margin which indicates that some customers are willing to pay a premium for the products and/or services of a company with CSR initiatives. Cho et. al (2019) confirmed that CSR performance has a partial positive correlation with profitability and firm value. In the relationship between CSR performance and profitability, only social contribution yields a statistically positive correlation. Awan and Saeed (2015) proved the fact that the firms which are highly involved in CSR get better reputations, better sales, and better profitability besides satisfying the customers. Hu et. al (2018) investigated that corporate social responsibility has a positive relationship with firm value and this relationship is weaker among firms that advertise heavily, since this company's CSR results in negative reactions from stakeholders. Tang et. al (2012) argued that when a firm engages in CSR slowly and consistently, focuses on related CSR dimensions, and starts with internal dimensions of CSR, CFP will be enhanced. The pace of the CSR engagement strategy, however, does not moderate the CSR–CFP relationship.

CSR provides a positive impact on financial performance until one next period, financial performance measured by ROA influence positively CSR only the next two years and there is a significant positive relationship between firm size and CSR (Santoso and Feliana, 2014). Ding (2016) showed that the value impact of CSR activities relies heavily on the industry-specific relative position of the firm. Only firms that distinguish themselves from their peers are associated with increased firm value. Wankeun and Park (2015) examined that the entire industry shows CSR has a positive effect on CFP in Korea, and the stakeholder theory seems valid. Industry analysis showed different results for each industry’s characteristics. The results also reveal the effect of CSR on CFP did not increase after the global financial crisis. The results suggest companies should improve CFP by taking a strategic approach to CSR. Sahore (2015) sought empirical results that showed that the relationship of CSR with some of the firm characteristics such as size and performance of the firms was found to be statistically significant. Maqbool and Zameer's (2018) study indicated that CSR has a positive impact on the financial performance of Indian banks. Skare & Golja (2015) presented the results of an econometric model that confirmed that CSR firms perform better financially than non-CSR firms on average. Ofurum and Ngoke (2022) Human Resource Development Centre (HRDC), Environmental Protection Cost (EPC), and Regulation Compliance Cost (DCC) were found to have positive relationships with the financial performance (ROA, ROE, and NPM) of oil and gas companies listed in Nigeria.

The debate regarding CSR and financial performance has led to another possibility, that, CSR works independently lacking any financial upshots. Both the variables are mutually exclusive and the relation is only by chance. The proponent of this line of reasoning argues that there are so many interposing variables between CSR and financial performance that a relationship hardly exists (Ullmann, 1985). McWilliams and Siegel (2000) investigated the relationship between CSR and financial performance in a sample size of 524 for a period of 6 years. The result shows upwardly biased estimates of the financial impact of CSR, but when the model was properly specified, by incorporating R&D, the result shows a neutral

effect of CSR on financial performance. Mamun et. al (2013) found that there is no existence of impact of the bank's net income on CSR expenditure i.e., CSR expenditure does not necessarily has a profit-increasing or performance-enhancing ability. Even though the results of study by Lin (2018) revealed an insignificant relationship between CFP and CSR, it is not an indication that CSR engagement is not vital or is unable to deliver any kind of competitive advantage in the long run. Perhaps the significant influence of CSR on CFP is not reflected in the firm's accounting performance but in its non-financial performance.

With all the studies pointing towards a unidirectional relationship between CSR and CFP i.e., CSR leading to positive/negative/neutral impact on CFP, only a few addressed the reverse relation between the two. Jhawar (2020) found that Companies' actual CSR spending has been shown to be significantly influenced by certain financial characteristics and corporate governance practices. The financial performance of companies is found to be impacted significantly by CSR spending. Hategan et. al (2018) identified the strong correlation between CSR and profit, as well as how companies behave when they have losses, whether they continue to do CSR activities, or they reduce the activities, or they give them up. The main results emphasized that the companies which implement CSR activities to a greater extent are more profitable in economic terms. Vitezić et. al (2012) confirmed the positive relationship between the sustainability concept of performance and financial results. Companies with better financial performance and larger size companies are more aware of their corporate social performance and report on it.

Among other firm-specific variables, firm size, age, and profitability were found to positively impact CSR, while leverage negatively impacted CSR. Panicker (2017) concluded a positive relationship between CSR spending and profitability, firm size, R&D, and advertising expenditure, and a negative relationship between CSR and debt to equity ratio. Sahore (2015) sought empirical results that showed that the relationship of CSR with some of the firm characteristics such as size and performance of the firms (Price Earnings) was found to be statistically significant. Panicker (2017) found a positive relationship between CSR spending and profitability, firm size, R&D, and advertising expenditure, and a negative relationship between CSR and debt to equity ratio is negatively related to CSR. Sarkar & Sarkar (2015) analyzed whether the characteristics of the companies such as age, profit after tax, net worth, and sales impacted CSR. Among all, PAT was not found to be impacting the CSR spending of companies.

Objectives of the Study:

Studies on the relationship between CSR and financial performance of the companies have been done, and have reported mixed results (Mishra and Suar, 2010). However, less empirical research has been done to find out the determinants of CSR in India, and most are small sample-based studies (Kansal et al, 2014). Furthermore, very few studies have been done keeping Corporate Social Responsibility as a dependent variable (Farooq et al, 2015) i.e. most researchers have assessed the impact of CSR on CFP but not vice versa. Since compliance with Section 135 is explained as a "soft mandate" (Rossow, 2015) it becomes crucial to examine whether companies are investing funds generated from higher earnings into CSR activities. This study hence fills the research gap by exploring the CSR-CFP link from a different perspective through examination of the impact of CFP on CSR.

Formulation of Hypothesis:

The study aims to scrutinize the actual CSR spending of the companies and examine whether corporate financial characteristics influence the CSR spending of the companies by formulating the following hypothesis: -

$H_{A:}$ The actual CSR spending is significantly related to the companies' accounting-based corporate financial characteristics ROE (Return on Equity).

$H_{B:}$ The actual CSR spending is significantly related to the companies' accounting-based corporate financial characteristics ROE (Return on Assets).

Research Methodology:

This section describes the sample and collection of data along with variables taken in the study, it then elaborates on the methods used to achieve the objectives of the study.

Sample Description:

The sample is drawn from the Nifty 500 listed on the NSE as of March 29, 2023. The NIFTY 500 Index represents about 96.1% of the free-float market capitalization of the stocks, it provides investors and market intermediaries with an appropriate benchmark that captures the performance of the top 500 most liquid and large market capitalization securities (NSE).

The final sample is taken from 284 companies after excluding firms that were not required to incur CSR expenditure by the Companies Act, 2013. The data on ROE, ROA, DER, Size, and CSR spending is collected from *Prowess*, the corporate database of the Centre for Monitoring of the Indian Economy (CMIE).

Variables Description:

Financial Performance: Financial Performance of a company is measured by Accounting based indicators, Return on Equity (ROE), and Return on Assets (ROA).

Return on Assets (ROA): The term return on assets (ROA) refers to a financial ratio that indicates how profitable a company is in relation to its total assets. Corporate management, analysts, and investors can use ROA to determine how efficiently a company uses its assets to generate a profit. The metric is commonly expressed as a percentage by using a company's net income and its average assets. A higher ROA means a company is more efficient and productive at managing its balance sheet to generate profits while a lower ROA indicates there is room for improvement.

Return on Equity (ROE): ROE measures the amount of profit a company generates with the money equity shareholders have invested in the company. Poor financial performance can lead to conservative use of resources for social responsibility.

Actual CSR Spending (%): It is the amount spent on CSR as a percentage of the average net profits of the immediately preceding three financial years. The criteria for calculating the actual CSR spending is as provided by section 135 of the Companies Act 2013.

Firm Size: It is a control variable, as larger firms are more observable and are pressurized more by the stakeholders to engage in a socially responsible way.

Debt to Equity Ratio (Financial Leverage): It is the extent to which a company uses fixed-income securities. Higher financial leverage results in higher interest payments, and thus higher risk. Higher interest payments also reduce the earning per share of the shareholders. In our study, Debt Equity Ratio has been taken to measure the financial leverage of a company. To study the impact of the financial performance of the company on CSR spending decisions in firms, CSR expenditure incurred by companies during the financial year is taken as the dependent variable, and financial performance measures as independent variables. The firm’s size, debt-equity ratio, and profitability are taken as control variables in the study. Table 1 describes the independent, dependent, and control variables used in the study.

Table 1: Description of Variables

Sr. No	Variable	Description	Symbol
Dependent Variable			
1.	CSR expenditure	Amount spent on CSR during the year	CSRspent
Independent Variable			
2.	Return on Equity	Net Income/Shareholders’ Equity	ROE
3.	Return on Asset	Net Income/Total Assets	ROA
Control variables			
4.	Debt Equity Ratio	Natural log of{Ratio of the total book}	DER
5.	Firm Size	Natural log of total assets	SIZE

Source: Authors’ Compilation

Methodology:

The study employs fixed effect regressions in panel data, based on the Hausman test which gave a statistically significant chi-square for the model. Data is examined for the presence of multicollinearity, heteroscedasticity, autocorrelation, stationarity, and normality.

The standard errors computed as regression estimates are robust to heteroscedasticity and autocorrelation. To test the effect of the financial performance of the company on CSR expenditure, the following model is used:

$Yit = \beta 0 + \beta a\ Xit\text{-}1 + \beta sCit\text{-}1 + vit$ where,

Yit : is CSR expenditure,

Xit : is the financial performance indicator, and

Cit : is a vector of control variables for firm i at time t. t: 2015, 2016,…2022.

Result Analysis:

To find the relationship between the financial performance of the firms and CSR spending, descriptive statistics, correlation matrix, and panel regression is used.

Descriptive Statistics and Correlation Matrix:

The descriptive statistics of the sample and correlation matrix are presented in Table 2 and Table 3 respectively:

Table 2: Descriptive Statistics

Variables	Observations	Mean	Std. Dev.	Min	Max
ROA	2271	9.514	7.77	-15.15	78.32
ROE	2268	17.717	13.531	-70.18	164.17
CSRSPENT	2242	329.539	858.799	.2	9220
SIZE	2272	370000	1290000	795.1	20700000
DER	2268	.673	1.482	0	12.71

Source: Analysis of research data (STATA output)

Table 3: Pearson's correlation matrix

Variables	(1)	(2)	(3)	(4)	(5)
(1) ROA	1.000				
(2) ROE	0.697*	1.000			
(3) CSRSPENT	0.023	0.024	1.000		
(4) SIZE	-0.187*	-0.082*	0.639*	1.000	
(5) DER	-0.328*	-0.060*	0.043*	0.219*	1.000

Source: Analysis of research data (STATA output)

The descriptive statistics display the mean, standard deviation, and minimum and maximum values of variables used in the study. The average CSR spending is 329 million approximately which indicates a positive response of companies to CSR guidelines. Among the sample companies, the average ROE is higher than ROA indicating higher returns for shareholders. Table 3 displays the pair-wise correlation, where values below 0.70 between independent variables in the correlation matrix confirmed the absence of the problem of multicollinearity in the data. All independent, as well as control variables, have a significant correlation with the CSR expenditure.

The fixed-effect regression analysis is carried out to examine the impact of financial performance on CSR expenditure in sample firms, Table 4 presents the results.

Table 4: Regression Results for Impact of Financial Performance on CSR Expenditure

	(1)	**(2)**
	CSRSPENT	**CSRSPENT**
ROA	3.583***	
	(1.238)	
ROE		1.277**
		(.639)
SIZE	0.000002***	0.00000006***
	(0.001)	(0.00003)
DER	4.643	-1.647
	(9.353)	(9.468)
Constant	178.339***	193.926***
	(22.509)	(20.546)
Observations	1971	1971
R-squared	.941	.941
Adj R^2	.931	.931
F-stat	30.256	29.544
Prob>F	0.0000	0.0000

Robust Standard errors are in parenthesis (*** p<0.01, ** p<0.05, * p<0.1)

Source: Analysis of research data (STATA output)

Table 4 depicts the significant value of the F statistics that confirm the statistical significance of all the models. The performance indicators explain approximately 93 percent variation in CSR expenditures. ROA and ROE have a positive significant impact on the level of CSR spending at 1% and 5% levels of significance respectively. Further, ROA exercises greater influence (3.58) as compared to ROE (1.28) in bringing change to the CSR expenditure of companies. Thus, the results confirm the positive influence of the company's performance on its CSR decisions.

Discussion:

According to the results, CFP has a significant effect on companies' CSR spending, meaning higher-performing companies are likely to spend more on CSR. It implies that the greater the company's CFP, the greater its CSR implementation. The study has practical implications for companies; given that ROA has a stronger impact on CSR, it suggests companies should not pamper investors with higher dividends from higher earnings by neglecting CSR investments, but rather meet society's expectations through allocation of funds towards CSR activities. Also, spending more on CSR brings a positive impact on the firm's market value and thereby ensures long-run profitability as the corporations gain legality by undertaking social responsibilities (Sharma and Talwar, 2005). In reality, the CSP-CSR relationship acts in a circular form, it simply exists in both directions. Our results support the view that CFP has a positive impact on CSR decisions, while various studies in this domain (Ofurum and Ngoke, 2022) have extensively put forward their perspective on how CSR improves the bottom line. They proved the fact that the firms which are highly involved in CSR initiatives go a long way to boost the public image of the firms, generate better sales, and better profitability besides satisfying the customers. Finally, a corresponding improvement in the aggregate financial performance of the firms. Also, some customers are willing to pay a premium for the products and/or services of a company with CSR initiatives, thus it's a win-win proposition for companies from all perspectives.

Our study has certain limitations too, it uses accounting-based ROE and ROA to measure CFP, and it is argued by some researchers that these are subject to bias from managerial manipulation and differences in accounting procedures (Branch, 1983). It is worth mentioning that although both ROE and ROA are measures of a firm's accounting performance, they are not a perfect substitutes for each other rather they are just alternatives (Z. Wang et al., 2020). A firm could increase its ROE by issuing more debt; nonetheless, this practice would not increase the firm's ROA. Consequently, future researchers may use different proxies to measure CFP such as market-based indicator, Tobin's Q. Additionally, future studies in this area can investigate the firms that have poor performance to observe whether low-performance indicators translate to decreased CSR for such firms. Also, it will be interesting to use an international sample of firms to examine the association between CSR and CFP.

Conclusion:

The empirical investigation of the relationship between CFP and CSR spending using a panel dataset of 284 Indian-listed firms from 2015 to 2022 highlights the existence of a bidirectional relationship between CFP and CSR. The study points toward the significance of management's efforts in enhancing the company's performance for greater CSR

expenditure. Firms could pursue CSR aggressively with a greater level of flexibility when they have adequate funds available. Therefore, with the increasing pace of change in market conditions, corporate managers should aim for higher performance by building their competitiveness in the market. This would ultimately lead companies towards long-term value creation by meeting stakeholders' expectations.

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